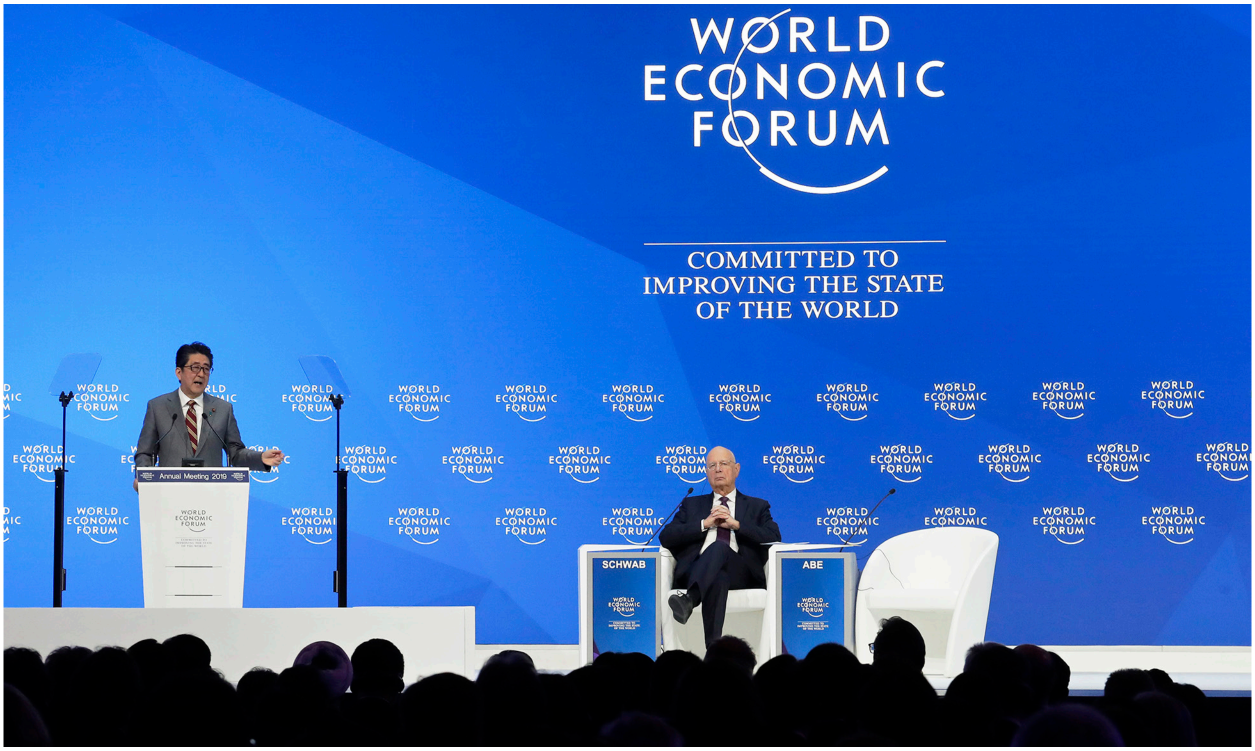
How Should We Then Invest?

By John Mauldin | January 25, 2019



The Extraordinary Power of the Political Arena
We Live in Interesting Times
Baltimore, New York, Boca Raton, and Back Home to Puerto Rico

"To be absolutely certain about something, one must know everything or nothing about it."

—*Henry Kissinger, former US Secretary of State*

This month I've discussed some possible pathways for 2019. But beyond that, for the past year or so, I have been talking about what I think may unfold over the next decade. The term I often use is The Great Reset, but in my mind it's more than just resetting global debt.

I think a number of equally important trends, all extraordinarily eventful, some amazingly positive and some frustratingly negative, when taken all together (which we'll have to, like it or not) will produce an era unlike anything previously seen in human history. I call it the Age of Transformation.

We can point back in history to events similar to each of the individual trends. We can even argue some of them happened relatively simultaneously… key word "relatively." The pace of this transformation will be breathtaking. For all of these changes to happen in roughly a decade will be unprecedented.

This is going to be an extraordinarily (and I use that word precisely) difficult period for those relying on historical precedent in their investment planning. You often see the phrase, "Past Performance Is Not Indicative of Future Results," and we need to re-examine what that means. Normally, we use it to say that the past returns of a particular investment may not resemble future returns. It's become part of the legal jargon, usually ignored.

I think we need to parse this further. We should be saying that the circumstances which produced the past performance may not be duplicated in the future. In other words, *This Time May Be Different*.

I have been pounding the drums for some time to say those circumstances are ***not only not going to be repeated in the next decade, they're going to be profoundly and deeply different***. Which means we are going to get different results than most people expect.

I want to be very clear here. I'm not being doom-and-gloom. When I say we will get different returns than history suggests, I mean we will need to *look at the world differently* to get the results we want. Investment "business as usual" is not going to cut it. Good and maybe even solid returns will be possible, but not with the old paradigms.

I believe we will enter recession within the next two years. Ray Dalio says we will be in a recession in 2020. Mark Yusko argues the US will be in recession by the end of 2019. Mark and Ray are smarter than I am. My crystal ball is a little bit cloudier as to exact timing.

In any case, it makes little difference to our portfolios whether recession strikes in 2019 or 2020. The benchmarks will drop between 40 and 50%—some more, some less. To the extent that you are exposed to stocks and other financial markets, your portfolio is going to take a hit.

The Extraordinary Power of the Political Arena

For a long time, politics have had a short-term significance to the market, but the long-term driving factor was a growing semi-free, semi-capitalistic economy. Further, for almost 40 years the Federal Reserve, beginning with Volcker, provided an era of extraordinarily low rates and easy money. It let governments and businesses worldwide grow their debts alarmingly fast. As I've demonstrated in other letters, global debt could easily reach $500 trillion in a few years. Investors and businesses act like that is normal and can continue.

At some point, we will have a recession exacerbated by extraordinarily high corporate debt. Just like subprime mortgage debt triggered the last recession, corporate debt will trigger the next one. (I am sure there will be congressional hearings and global angst, and new rules will be instituted to limit future *corporate* debt, at the same time ignoring and indeed increasing government debt. Sigh.)

This corporate debt will precipitate a liquidity crisis and create havoc in all sorts of "unrelated" markets. Investors will learn, once again, that all asset classes are globally correlated in a crisis. There will be few places to hide.

But then the recession will end, as all recessions do, and recovery begin, because that is what happens after recessions. Except it will be different this time.

Recovery from the Great Recession was the slowest on record. The next recovery will be even slower. I have written about that, citing Lacy Hunt and others. ***Debt that is not self-funding*** is future consumption brought forward. We are currently enjoying consumption and growth that cannot happen in the future. Debt, then, is a drag on future growth, and the amount of debt the world now has will be a monster drag on future growth. (Note the distinction between debt for current consumption and debt for future production. There is an enormous difference.)

Recessions always bring higher unemployment, on top of technology-driven job losses. This will exacerbate the current political tensions. Humans want scapegoats. Many will blame markets and capitalism, when we have neither free markets or true capitalism. The progressive left's siren song—guaranteed basic income, free college, free everything, etc.—will begin to play everywhere.

If you haven't already heard of the economically illiterate insanity called Modern Monetary Theory or MMT, you will. It says we don't need to worry about government debt; we should simply monetize it. Create and spend whatever we need for the common good. They produce fancy equations and rationales, but monetization is the bottom line. It essentially what Alexandria Ocasio-Cortez and others in her world espouse. They talk about raising taxes on the rich, but there's simply not enough money to do what they propose, even if you take everything the rich have. The arithmetic doesn't add up. So they will have to increase the debt and eventually monetize it. Which is exactly what Japan has done, and seemingly succeeded.

It is that experiment that we in the US are eventually going to try. Past performance is not indicative of future results. With a vengeance. Except that we know exactly what happened in other countries that tried this. Our experiment will yield a new witches brew of problems and opportunities, which we can't yet predict. Buy and hold investing will be perilous. Active management is once again going to be paramount.

US government debt will easily reach $30 trillion within three years after the next recession. Once we begin that next economic experiment, there will relatively shortly be another recession, markets will have an even greater distress situation, and the debt will quickly expand to $40 trillion. Pensions and government deficits will be completely upside down. And then the real fun will begin: quantitative easing on a scale that makes the Bernanke years look like an elementary school picnic. We will simply have no choice.

Now, the world will not come to an end. Markets and (most, though not all) businesses will figure out how to survive. New businesses will keep launching. New technologies will thrive. We will continue to need food, shelter, transportation, communication, and all the things we think of as normal. We will all need medical attention but the potential for living longer, perhaps far longer, will bring investment opportunities everywhere. The challenge will be finding them and getting access. In short, economic activity will still be going on.

This will all happen while technology "eats" jobs faster than it creates them. It was all well and good when we went from 80% of the workforce on farms to 1% today, but that happened over several generations and centuries. We are going to see that kind of upheaval in many industries in half a generation. Can you say frustrated workers? People wishing that they can have their jobs protected? Wanting the government to do something?

I think the political arena will become more important to markets in the coming decade than it has ever been. That is not to say we can't figure it out. But if you are looking at past historical performance to guide your portfolio, you are unlikely to be happy with the outcome.

We are getting ready to enter an era unlike anything in our own experience or in our history books. Analogies? Surely. History, and economic and political history, will be ever more important.

George Box (a British statistician) was the first to say that, "All models are wrong, but some are useful." Let me adapt that to say that all models based on history are wrong, but some are useful. And those based on a proper reading of history will be very useful indeed. (Hat tip for the quote at the beginning and this one: Seth Klarman, see below.)

We Live in Interesting Times

It is said that a Chinese curse is, "May you live in interesting times." For better or worse, we live in interesting times. For most of us it won't be violent, which is what usually accompanied historical interesting times, so for that we can be grateful. But it will be emotionally wrenching.

Seth Klarman, of Baupost Group in Boston, one of the world's greatest value investors (right up there with Warren Buffett) writes an annual letter. I've always found it must-reading when I can get my hands on it. Klarman's latest letter is beginning to make the rounds, and it is certainly circulating in Davos, as it takes a more dire and political tone than his normal musings. He certainly illustrates my point that we live in interesting times. (If someone can get me an introduction to Seth so that I can arrange a meeting, I would be extraordinarily grateful.)

I am going to finish with some selected quotes from Klarman's letter, leaving out some of the more incendiary remarks, even though they are no less true. Here's Seth.

"Social frictions remain a challenge for democracies around the world, and we wonder when investors might take more notice of this. The recent "yellow vest" marches in France, which subsequently spread to Belgium, Holland, and Canada, began as a petition against fuel tax hikes, and grew through social media into a mass protest movement led by suburban commuters, small business owners, and truck drivers.The demonstrations, which appear to have broken out spontaneously throughout the country, became widespread and even violent. While the French government is clearly concerned—in December, it reversed the planned tax increases while announcing a higher minimum wage—the financial markets have taken the unrest largely in stride, as the French 10-year note at year-end yielded a meager 70 basis points...

Social and economic advancement in America today seems increasingly dependent on demography and geography. The economic advantages enjoyed by college graduates continues to grow. Unsurprisingly, income growth in most major metropolitan areas surpasses gains in rural areas of the country. Economic inequality continued to worsen in 2018, and for many, real wages have not increased in decades. It seems clear that economic anxiety contributed to the election of Donald Trump in 2016.

The divide between Americans has been exacerbated by the echo chambers of modern-day media and the internet. Many have written of how, in only about four decades, an America of three broadcast networks has become an America of hundreds of cable channels. A few decades ago, we had less connectivity but more connection. David Brooks and others write regularly about the challenges of increased loneliness and isolation. A person today can have a thousand Facebook friends—and few, if any, actual friends."

….Amid all this turmoil, should investors simply hunker down and keep their focus on markets? That might be a challenge. By way of illustration, on December 18, on the FedEx earnings call, CEO Frederick Smith noted that "most of the issues that we're dealing with today are induced by bad political choices, I mean, making a bad decision about a new tax, creating a tremendously difficult situation with Brexit, the immigration crisis in Germany, the mercantilism and state-owned enterprise initiatives in China, the tariffs that the United States put in unilaterally. So you just go down the list, and they're all things that have created macroeconomic slowdowns."

These days, Americans do not seem to agree on much of anything. Some of it is today's politics: "Deep state" or dedicated civil servants? "Witch hunt" or legitimate investigation into crimes? "Fake news" or free press? "Alternative facts" or facts? Accomplished adversary or "lock her up?" And some of it goes beyond politics into the realms of scientific inquiry and American values. Climate change or "climate hoax?" Refugees seeking sanctuary or "caravan of foreign invaders?"

Does this matter? We think it does. It's hard for our leaders to guide us when we don't agree on our values or even on how we decide what is true. Worse, our enemies, including but not limited to Russia's autocratic government, are using social media and internet postings to confuse us and divide us further. They know which hot buttons to push. Moreover, our willful disbelief of facts, truth, and science increases the chance that we will fail to recognize or take seriously growing threats. In 1993, Senator Daniel Patrick Moynihan, who famously said that "everyone is entitled to his own opinion, but not to his own facts," observed that America was "defining deviancy down." His point was that behavior that had once been seen as deviant was now considered acceptable. To paraphrase Moynihan, today we may instead be defining reality down.

This post-truth moment is quite dangerous. Imagine an incident that threatens national security. Will Americans see eye-to-eye on the seriousness of the threat? If our leaders are truth-challenged, will Americans believe the official explanation of the threat and the wisdom of the proposed response? Should they?

…We would argue vehemently that democracy, and the liberties and protections it provides, is not just of importance to individual citizens, but also to businesses and markets. In a democracy, businesses have the benefit of equal treatment under the law, including unbiased regulation.

We would also argue that social cohesion is essential for those who have capital to invest. Businesses need a long-term horizon to plan, and social unrest makes planning more difficult. It can't be business as usual amidst constant protests, riots, shutdowns, and escalating social tensions. It is not hard to imagine worsening social unrest among a generation that is falling behind economically and feels betrayed by a massive national debt that was incurred without any obvious benefit to them. If things get bad enough, we could see taxes once again raised to confiscatory levels. We should all be rooting for (and acting to support) social cohesion and a renewal of the American dream.

John here again. George Soros this week said that we are in a cold war with China that threatens to turn into a hot war. While Soros and I agree on little politically, I did find my head nodding at times in his latest CNBC interview. Then Luke Gromen of Forest for the Trees wrote about change in the geopolitical climate, which is not his usual beat. I have become a fan of his writing. Saying US national security may be more important than risk asset performance for the first time in decades, Gromen foresees (quoting his summary):

1. *Potential rule change: US national security may be more important than risk asset performance for the 1st time in 35+ years (but risk assets don't seem to realize this yet).*

2. *If we are moving back to a "Cold War" world where US policy is driven more by the national security establishment than the Wall Street/Treasury establishment (as has been the case for the past 30+ years), then it would seem the odds are good that the chart on the front page of the attached pdf would mean revert, implying as much as a 30–60% drop in corporate profits as a % of GDP just to return to the levels that prevailed during the last Cold War, before cheap Chinese labor & (at least temporarily disappearing) Fed largesse elevated US corporate profitability to all-time high %s of GDP.*

3. *If a new Cold War is indeed breaking out, it would in turn seem to have severe implications for the global & US corporate debt & equity markets—it is HIGHLY unlikely that any of this money was borrowed assuming a 30–60% drop in US corporate profits as a % of GDP was even remotely possible, & on many metrics (IG, HY, leveraged loans, US equities v. ROW), valuations are quite stretched already.* ***There are record levels of leverage in the US corporate debt market, & the rules appear to be changing for national security reasons in a manner quite unfriendly to corporate margins!***

I am in Washington DC for a personal meeting with Andrew Marshall, whom I mentioned two weeks ago. On that occasion, he had to go to the emergency room. Forgivable since he is 97 years old. But he was up and his usual vigorous self today. There were also two US defense strategy mavens in the room. The topic turned to China.

It soon became troubling, at least to me. Andy noted that he had been warning the US government about China's real intentions since the 1980s. (Again, he was appointed by Nixon to run the Defense Department's futurist think tank. He retired three years ago at 94. Every president reappointed him. He is the most significant figure in US geopolitical strategy that you have never heard of, because he never wanted anyone to know who he was. Chinese leaders read everything he wrote. His pictures are on their walls, literally. I can't stress enough how important and influential he is.)

I asked about some of the China analysis I've seen. These experts confirmed everything that I had read and then doubled down. The geopolitical risks are serious. We in the West simply don't understand the Chinese mindset or their intentions, even though they write strategic papers every other year detailing exactly what they are thinking and doing. There should be no surprises. But we ignore these writings as political noise and then try to exploit the vast (and real) potential of Chinese markets, yet it may not work out the way we hope. I will have to write on this in a later letter.

But the point is that we do indeed live in interesting times. We simply can't expect the old investment paradigms to meet the challenges of the future. Past performance is indeed not indicative of future results.

I can't close this letter without pointing out we will cover all these topics at the upcoming Strategic Investment Conference in Dallas May 13–16. We will be dealing with China, global debt, geopolitics, the upcoming elections, markets, new technologies, social upheaval, and much more. We will be talking about specific investment opportunities and how to structure your affairs.

This will be my 16th Strategic Investment Conference. From the very beginning, I have created a conference that I want to attend. I invite speakers/thought leaders from whom I want to learn. This is the most extraordinary lineup of speakers that I have ever been able to assemble, including former President George W. Bush, Howard Marks, Felix Zulauf, Carmen Reinhart, Jim Mellon, Bill White, Simon Hunt, Lakshman Achuthan, David Rosenberg, George Friedman, Lacy Hunt, Mark Yusko, Liz Ann Sonders, Grant Williams, and more.

There will be speakers you have never heard of that will blow you away. I can guarantee that. My Rolodex has gotten pretty extensive over the years.

Conferences have become my personal art form. I design them in building blocks to develop themes that help you plan your own personal future. "Protect and Participate" is the model I think we need to embrace: Protect what we have, participate in the future's potential.

We do live in interesting times. It is tempting to hunker down, buy gold, and just try to survive. I reject that strategy. Life is so much more intricate, complex, and full of powerful opportunities. It is meant to be lived. Sitting with Andy Marshall this afternoon, 30 years my senior, inspired me.

I want to communicate that inspiration to you. I want to inspire you to live and grow and prosper. My absolute best way to do that is at the Strategic Investment Conference. Experiencing these ideas in person is exponentially more powerful than reading about them.

I hope you can join me as we work our way into the future. Uncertain? Absolutely. Daunting and full of potential dangers? Assuredly. Will we need wisdom and guidance and compatriots in our journey? More than ever.

But it will be exhilarating and challenging and full of opportunities. I hope to see you in Dallas. Click here to learn more about the Strategic Investment Conference.

Baltimore, New York, Boca Raton, and Back Home to Puerto Rico

As I write this, I'm on my way to Baltimore to see 300-year-old mice—or ones that have aged the equivalent of 300 human years. Oh, dear gods, how the world is going to change. We will look back in the late 2030s and wonder why we all worried so much. And this is just one of a dozen different experiments that I personally know about. There must be hundreds of others. What might humanity achieve if we could only get governments out of the way? I only say that semi-humorously.

Then I am off to New York where I have meetings Sunday night and Monday, before I fly on Tuesday to finally see Shane again in Boca Raton. There I will be speaking at a conference and meeting with my friends Doug Kass and Michael Lewitt, who live in the area. I will be on stage with Grant Williams and Martin Barnes, old friends and comrades, where we will be expected to espouse wisdom and knowledge, but frankly, we will just be having the usual intellectually stimulating and aggressive in-your-face fun, and conference attendees will get to listen to us. That's the best kind of panel.

It seems strange to say I'm going back *home* to Puerto Rico. But in less than two months, and at age 69 for me and a number that I will not mention for Shane, it has become home. Home is where the heart is? Texas will always be my home, then. But for now, Puerto Rico is where I want to have my closet.

And with that, I will hit the send button. As often happens, I fully intended this to be a short letter but it just never turns out that way. One day I am actually going to have a truly short letter. You should keep reading just in the anticipation of it. And with that humorous note, let me wish you a great week and more than a few occasions to be with friends!

Your optimistic and simultaneously worried about the future analyst,

John Mauldin
subscribers@mauldineconomics.com

http://www.mauldineconomics.com/members

Thoughts from the Frontline is a free weekly economic e-letter by best-selling author and renowned financial expert, John Mauldin. You can learn more and get your free subscription by visiting www.MauldinEconomics.com.

To subscribe to John Mauldin's Mauldin Economics e-letter, please click here: http://www.mauldineconomics.com/subscribe

To change your email address, please click here: http://www.mauldineconomics.com/change-address

Thoughts From the Frontline and MauldinEconomics.com is not an offering for any investment. It represents only the opinions of John Mauldin and those that he interviews. Any views expressed are provided for information purposes only and should not be construed in any way as an offer, an endorsement, or inducement to invest and is not in any way a testimony of, or associated with, Mauldin's other firms. John Mauldin is the Chairman of Mauldin Economics, LLC. He also is the President and investment advisory representative of Mauldin Solutions, LLC, which is an investment advisory firm registered with multiple states, President and registered Principle of Mauldin Securities, LLC, a FINRA and SIPC, registered broker-dealer. Mauldin Securities LLC is registered with the NFA/CFTC, as an Introducing Broker (IB) and Commodity Trading Advisor (CTA).

This message may contain information that is confidential or privileged and is intended only for the individual or entity named above and does not constitute an offer for or advice about any alternative investment product. Such advice can only be made when accompanied by a prospectus or similar offering document. Past performance is not indicative of future performance. Please make sure to review important disclosures at the end of each article. Mauldin companies may have a marketing relationship with products and services mentioned in this letter for a fee.

PAST RESULTS ARE NOT INDICATIVE OF FUTURE RESULTS. THERE IS RISK OF LOSS AS WELL AS THE OPPORTUNITY FOR GAIN WHEN INVESTING IN MANAGED FUNDS. WHEN CONSIDERING ALTERNATIVE INVESTMENTS, INCLUDING HEDGE FUNDS, YOU SHOULD CONSIDER VARIOUS RISKS INCLUDING THE FACT THAT SOME PRODUCTS: OFTEN ENGAGE IN LEVERAGING AND OTHER SPECULATIVE INVESTMENT PRACTICES THAT MAY INCREASE THE RISK OF INVESTMENT LOSS, CAN BE ILLIQUID, ARE NOT REQUIRED TO PROVIDE PERIODIC PRICING OR VALUATION INFORMATION TO INVESTORS, MAY INVOLVE COMPLEX TAX STRUCTURES AND DELAYS IN DISTRIBUTING IMPORTANT TAX INFORMATION, ARE NOT SUBJECT TO THE SAME REGULATORY REQUIREMENTS AS MUTUAL FUNDS, OFTEN CHARGE HIGH FEES, AND IN MANY CASES THE UNDERLYING INVESTMENTS ARE NOT TRANSPARENT AND ARE KNOWN ONLY TO THE INVESTMENT MANAGER. Alternative investment performance can be volatile. An investor could lose all or a substantial amount of his or her investment. Often, alternative investment fund and account managers have total trading authority over their funds or accounts; the use of a single advisor applying generally similar trading programs could mean lack of diversification and, consequently, higher risk. There is often no secondary market for an investor's interest in alternative investments, and none is expected to develop. You are advised to discuss with your financial advisers your investment options and whether any investment is suitable for your specific needs prior to making any investments.

All material presented herein is believed to be reliable but we cannot attest to its accuracy. Opinions expressed in these reports may change without prior notice. John Mauldin and/or the staffs may or may not have investments in any funds cited above as well as economic interest. John Mauldin can be reached at 800-829-7273.